REG-128224-06

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LEGAL PROCESSING DIVISION
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Via email notice.comments@irscounsel.treas.gov and mail
Internal Revenue Service
P.O. Box 7604 Ben Franklin Station
Washington, DC 20044

Re: Section 67 Limitations on Estates and Trusts; REG-128224-06;
72 FR 41243 (July 27, 2007)

To Whom It May Concern:

The California Bankers Association ("CBA") appreciates this opportunity to comment on the Internal Revenue Service's ("IRS") proposed amendments to 26 CFR 1.67. CBA is a professional non-profit organization established in 1891 and represents most of the depository financial institutions doing business in the state of California. CBA frequently submits comment letters on regulatory proposals that significantly affect the business of banking. Many CBA members are actively engaged in the trust business and act as fiduciaries to individual and institutional clients, providing such services as trust administration, investment management, custody of assets, tax preparation, and accounting.

CBA has reviewed a draft of the letter to the IRS by the American Bankers Association ("ABA") with respect to the referenced proposal, and concurs with the views stated therein. The issue, simply framed, is whether investment management fees are fully deductible by trusts pursuant to Section 67(e) of the Internal Revenue Code ("IRC" or "Code"). The IRS is proposing to identify by regulation the kinds of trust administration expenses that may be fully deducted from a trust's adjusted gross income (generally, those that are "unique" to the administration of a trust or estate), and those that are deductible only to the extent that they exceed two percent of adjusted gross income (expenses that may be incurred outside of the context of a trust or estate).

As more fully discussed in the ABA's letter, this issue has been actively litigated in the federal courts. One view is that such fees are fully deductible because they would not be incurred if the underlying assets were not held in trust, while the competing view is that these fees are not fully deductible because they can be incurred outside of the trust context. Yet another view is that a full deduction is warranted only for those costs that *could not have been*

incurred by an individual property owner. The issue is currently before the U.S. Supreme Court in *Knight v. IRS*, a case in which the CBA joined the ABA in filing an amicus curiae brief on behalf of Knight.

The ABA cited three reasons why the IRS should delay any consideration of regulatory action until after the Supreme Court has decided the matter. These reasons are that the proposal contradicts the plain meaning of Section 67, ignores the significant and extensive fiduciary responsibilities imposed on trustees, and that it would be administratively impractical and costly to implement. We concur with those reasons without reanalyzing them, but would like to add the following comments.

The proposal would apply the two percent floor to expenses that an individual outside of a trust context "*could* not have incurred," a standard that is in marked contrast to the statutory standard, which allows the deduction for expenses that "*would* not have been incurred if the property were not held in such trust or estate." IRC Section 67(e). "Could" not have incurred suggests an impossibility. By this standard, since an individual could hire a professional for investment advice, therefore such fees are not unique to a trust and thus not fully deductible. But this result is much more restrictive than is warranted by the Code. Section 67 focuses more on the nature of fiduciary activities as distinguished from individual ownership and management of property.

The key characteristic of fiduciary activities is that fiduciaries are subject to unique statutory duties. In California, banks acting as a fiduciary or trustee have legal duties to administer a trust in accordance with law and the trust document (California Probate Code Section 16000, hereafter "PC"), to administer a trust solely in the interest of beneficiaries (PC 16002), to treat beneficiaries impartially (PC 16003), to avoid conflicts of interest (PC 16004), and to exercise discretionary powers reasonably (PC 16080). None of these and other duties applies outside of a trust context.

Of particular note is Probate Code Section 16007, which states: "The trustee has a duty to make the trust property productive under the circumstances and in furtherance of the purposes of the trust." While it may make good sense for an individual to obtain management advice, a trustee that is responsible for investment of trust assets has a legal duty to be a prudent investment manager. California trust law has incorporated this concept in Probate Code Section 16047, which in substance imposes the same duties as the Uniform Prudent Investor Act. It is the existence of this duty that differentiates the individual investor from the trustee, a duty that may be fulfilled by a trustee or require the retention by a trustee of expert investment assistance. As the Sixth Circuit Court stated in *O'Neill v. IRS*, 994 F.2d at 304:

> Unlike trustees, individual investors are not required to consult advisors and suffer no penalties or potential liability if they act negligently for themselves. Therefore, fiduciaries uniquely occupy a position of trust for others and have an obligation to the beneficiaries to exercise proper skill and care with the assets of the trust.

It is this distinction that IRC Section 67 makes. That it is possible that an individual could incur similar costs should be of no consequence in applying the statute. For these reasons, the IRS proposed rule is not defensible as a matter of administrative law, which prohibits an executive agency from promulgating regulations that are not authorized by, or contradicts, the underlying statutory authority.

The proposal would also require fiduciaries to unbundle fees charged to administer trust accounts in order to distinguish "unique" components of trust fees from those that are not unique. Typically, banks charge each trust account a single fee for administration that encompasses fiduciary services such as custody, tax return preparation, and investment services. We concur with the ABA's comments that this proposal would be extremely difficult to administer.

Finally, the proposal would become effective for payments made after the date final regulations are published in the Federal Register. Since banks would be required to undergo significant changes and training to unbundled fees, any final rule should include a transition period of not less than one year.

CBA appreciates this opportunity to voice its concerns. We urge the IRS to withdraw its proposal. We believe it is inconsistent with the Code, it fails to acknowledge fiduciaries' statutory duties, and it would be extremely burdensome to implement.

Respectfully submitted,

Leland Chan
SVP/General Counsel